BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF DELMARVA POWER AND LIGHT COMPANY FOR AN INCREASE IN ELECTRIC BASE RATES AND MISCELLANEOUS TARIFF CHANGES (FILED SEPTEMBER 18, 2009)	]]]]]	PSC Docket No. 09-414

IN THE MATTER OF THE APPLICATION OF DELMARVA POWER AND LIGHT COMPANY FOR APPROVAL OF A MODIFIED FIXED VARIABLE RATE DESIGN FOR ELECTRIC RATES (FILED JUNE 25, 2009)	]]]]]	PSC Docket No. 09-276T

DIRECT TESTIMONY OF

ANDREA C. CRANE

RE: COST OF CAPITAL
RATE DESIGN
AND CERTAIN POLICY ISSUES

ON BEHALF OF

THE DIVISION OF THE PUBLIC ADVOCATE

February 10, 2010

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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is Andrea C. Crane and my business address is PO Box 810, Georgetown, Connecticut 06829. (Mailing Address: 199 Ethan Allen Highway, Ridgefield, CT 06810).

Q. By whom are you employed and in what capacity?

A. I am President of The Columbia Group, Inc., a financial consulting firm that specializes in utility regulation. In this capacity, I analyze rate filings, prepare expert testimony, and undertake various studies relating to utility rates and regulatory policy. I have held several positions of increasing responsibility since I joined The Columbia Group, Inc. in January 1989. I became President of the firm in 2008.

Q. Please summarize your professional experience in the utility industry.

A. Prior to my association with The Columbia Group, Inc., I held the position of Economic Policy and Analysis Staff Manager for GTE Service Corporation, from December 1987 to January 1989. From June 1982 to September 1987, I was employed by various Bell Atlantic (now Verizon) subsidiaries. While at Bell Atlantic, I held assignments in the Product Management, Treasury, and Regulatory Departments.

Q. Have you previously testified in regulatory proceedings?

A. Yes, since joining The Columbia Group, Inc., I have testified in approximately 310 regulatory proceedings in the states of Arizona, Arkansas, Connecticut, Delaware, Hawaii, Kansas, Kentucky, Maryland, New Jersey, New Mexico, New York, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Vermont, West Virginia and the District of Columbia. These proceedings involved electric, gas, water, wastewater, telephone, solid waste, cable television, and navigation utilities. A list of dockets in which I have filed testimony is included in Appendix A.

Q. What is your educational background?

A. I received a Master of Business Administration degree, with a concentration in Finance, from Temple University in Philadelphia, Pennsylvania. My undergraduate degree is a B.A. in Chemistry from Temple University.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. On September 18, 2009, Delmarva Power and Light Company ("DPL" or "Company") filed an Application with the State of Delaware, Public Service Commission ("PSC" or "Commission") seeking an increase in its base rates for electric service. The Company is requesting a base rate increase of $27.6 million, or an increase of approximately 19.1% on base distribution revenues.

The Columbia Group was engaged by the Division of the Public Advocate ("DPA") to review the Company's filing and to provide recommendations to the Commission on revenue requirement, cost of capital, rate design, and certain regulatory policy issues. James

D. Cotton, Chairman of The Columbia Group, is filing testimony on revenue requirement issues. I am filing testimony on cost of capital, on the Company's request to defer pension costs incurred in 2009, and on the Company's request to implement a tracking mechanism to track and defer benefit and uncollectible costs between base rate cases. I am also providing testimony on the Company's proposed rate design and on its proposal to introduce a new service classification, Telecommunications Network Service ("TN").

III. SUMMARY OF CONCLUSIONS

Q. Is there a unifying theme to the Company's proposals that you are addressing in your testimony?

A. Yes. For the most part, the Company's proposals are designed to minimize shareholder risk by shifting much of that risk onto the Company's ratepayers, without a commensurate reduction to the return on equity risk premium. With deregulation, the risk associated with the majority of the Company's revenue requirement was shifted to ratepayers. As noted, the Company's proposal results in a rate increase of 19.1% on base distribution revenue but only 4.0% on total revenues, indicating that approximately 80% of the Company's revenues are obtained from sources other than base rates. The vast majority of these other revenues relate to electric supply revenues, which are a direct pass-through to customers. Thus, the Company bears no risk of under-recovery for the overwhelming portion of its costs.

With this filing, DPL attempts to provide shareholders with the same risk reduction for the remaining 20% of DPL's cost of service, i.e., the distribution component. The

Company's filing includes a new modified fixed variable rate design, which essentially guarantees the DPL will achieve its targeted level of revenue, regardless of variations in usage due to weather, conservation, economic conditions, or other factors. In addition, the Company is proposing that it be permitted to recover from ratepayers higher than anticipated benefit costs incurred in 2009. The Company is also proposing a tracker mechanism that would provide guaranteed recovery of its pension, other post-employment benefit ("OPEB") costs, and uncollectible costs. Finally, the Company is proposing a Utility Facility Relocation Charge ("UFRC") rider, to provide for immediate recovery of costs associated with relocations of distribution facilities that are mandated by the Delaware Department of Transportation ("DOT") or other state agencies.

In spite of these proposals, the Company is only proposing a 25 basis point reduction to its return on equity. The Company attributes this reduction to the impact of its modified fixed variable rate design. No return on equity reduction is being proposed for the other mechanisms that will reduce shareholder risk. This 25 basis point reduction is wholly inadequate to compensate ratepayers for the increased risk that they would bear if the Company's proposal were adopted.

In evaluating DPL's proposals, the PSC should be mindful of the fact that regulation is a substitute for competition, and that there are no guarantees in the competitive world. To the extent that any of these risk-reducing proposals are accepted by the PSC, due to legislature mandates for example, then the PSC should ensure that there is a commensurate reduction to the Company's return on equity award.

Q. What are your conclusions concerning the Company's proposed cost of capital, modified fixed variable rate design, new TN rate, recovery of past pension costs, and proposed new tracking mechanisms?

A. Based on my analysis of the Company's filing and other documentation in this case, my conclusions are as follows:

1. I recommend that the Commission adopt a pro forma capital structure for DPL that consists of 47.52% common equity and 52.48% long-term debt (see Schedule ACC-1). This is the capital structure proposed by DPL.
2. The cost of long-term debt of 5.45% proposed by DPL is reasonable and should be adopted by the PSC.
3. If the modified fixed variable rate design is adopted by the PSC, then the Company has a cost of common equity of 7.52%. If the modified fixed variable rate design is not adopted by the PSC, then the Company should be awarded a return on common equity of 9.58%. (see Schedule ACC-2)
4. Based on my recommended capital structure and capital cost rates, if the modified fixed variable rate design is adopted, then I recommend that the Commission adopt an overall cost of capital of 6.43% for DPL. If the modified fixed variable rate design is not adopted, then I recommend an overall cost of capital of 7.41%. (see Schedule ACC-1)
5. My recommendations regarding cost of equity and the Company's overall cost of capital should be reduced further if the PSC accepts other proposals by DPL to shift risk from shareholders to ratepayers.

6. Given the legislature mandate that decoupling be adopted by December 31, 2010, the PSC should accept DPL's proposed framework for a modified fixed variable rate design. The PSC should convene a working group to resolve specific issues that may arise in implementing the Company's proposal.

7. DPL's proposal to create a new TN service class to serve one cable operator will shift costs onto small and medium sized commercial customers and should be rejected.

8. DPL's proposal to require ratepayers to compensate shareholders for incremental 2009 pension costs should be rejected.

9. DPL's proposal to implement a tracking mechanism to track pension, OBEP, and uncollectible costs and to recover these costs on a guaranteed basis from ratepayers should be rejected.

10. I understand that the legislature has approved the implementation of a UFRC. Therefore, DPA is not opposed to the implementation of a UFRC that is consistent with the legislation.

IV. COST OF CAPITAL AND CAPITAL STRUCTURE

Q. What is the cost of capital and capital structure that the Company is requesting in this case?

A. The Company has utilized the following capital structure and cost of capital:

	Percent	Cost	Weighted Cost
Long Term Debt	52.48%	5.45%	2.86%
Common Equity	47.52%	10.75%	5.11%
Overall Cost of Capital			7.97%

In its Application, DPL stated that its proposed cost of equity has been reduced by 25 basis points to reflect the reduction in risk that will occur if its proposed modified fixed variable rate design is adopted. If the proposed rate design is not adopted, the Company stated that its return on equity should be increased to 11.00%, which would increase DPL's revenue requirement (and therefore its rate increase request) by approximately $900,000.[1]

A. Capital Structure

Q. Are you recommending any adjustment to the capital structure proposed by DPL?

A. No, I am not recommending any adjustment to the capital structure proposed by DPL.

Q. Why aren't you recommending that the Commission include short-term debt in DPL's capital structure for ratemaking purposes, as you have recommended in some other cases?

1 Application for a Change in Electric Rates filed September 18, 2009, page 3.

A. Short-term debt is an appropriate component of a utility's capital structure if it is regularly and consistently utilized for financing. Most utilities do utilize significant amounts of short-term debt, and I often testify that this debt should be included in a utility's capital structure. According to the response to PSC-COC-4, short-term debt has been utilized over the past two years, although it has not been used every month during that time. As shown in that response, the Company has three sources of short-term debt: the sale of commercial paper, Pepco Holding Inc.'s ("PHI") credit facility, and a short-term bank loan.

In a prior litigated Artesian Water Company base rate case, the Hearing Examiner and the Commission rejected my recommendation to include short-term in that company's capital structure. In his Recommended Decision, the Hearing Examiner recommended that "the Commission again remove the short-term debt in this case in order to maintain an appropriate matching between the capitalization supported by the ratepayers and the capitalization used for setting rates... ."[2] Thus, the Hearing Examiner reached the conclusion that short-term debt was primarily associated with temporary financing of capital projects. Moreover, since Artesian Water Company was not requesting the inclusion of construction work in progress ("CWIP") in rate base, the Hearing Examiner apparently felt that it would be inappropriate to include short-term debt in the capital structure. The Commission adopted the Hearing Examiner's recommendation in that case.

2 Recommended Decision, Docket No. 04-42, paragraph 132.

As I stated in that case, there are other components of rate base, in addition to CWIP, that are routinely financed by short-term debt, such as materials and suppliers and insurance prepayments. Thus, while I continue to believe that short-term debt should be included in a utility's capital structure, I have decided not to include short-term debt in my recommendation in this case since this issue has been addressed by the Commission.

Q. Is there one distinction between this case and the Artesian rate case that should be considered?

A. Yes, there is. In this case, DPL is requesting the inclusion of CWIP in rate base. Mr. Cotton is recommending that CWIP be excluded from rate base. However, if the Commission accepts DPL's proposal to include CWIP in rate base, then it would certainly be appropriate to include short-term debt in the Company's capital structure. If short-term debt was included in the Company's capital structure, the impact would be further reduction to the overall costs of capital that I have reflected in my testimony.

Q. Has DPL requested recovery of costs associated with the PHI credit facility?

A. Yes, it has. DPL has included in its claim a rate base adjustment of $159,588 and an operating expense adjustment of $132,098 relating to a short-term credit facility operated by PHI. As discussed in Mr. Cotton's testimony, there is no rationale for including these costs in utility rates if ratepayers are not receiving any of the benefit of this short-term credit facility. Moreover, the only way that ratepayers would receive benefit from this credit facility is if the Company's capital structure included the average balance of short-term debt and the weighted average short-term debt cost. The Company is attempting to make ratepayers pay for a credit facility without providing ratepayers with any resulting benefit. The Company cannot have it both ways, i.e., exclude short-term debt from the capital structure but include the costs of the credit facility in its revenue requirement. Accordingly, I fully support Mr. Cotton's adjustment to eliminate the costs associated with the PHI credit facility from the Company's revenue requirement. If the Commission permits DPL to recover any of these credit facility costs from ratepayers, then the Company's capital structure should be amended to reflect the inclusion of short-term debt.

B. <u>Cost of Equity</u>

Q. What is the cost of equity that the Company is requesting in this case?

A. DPL is requesting a cost of equity of 10.75%. As noted above, if the Company's proposed modified fixed variable rate structure is rejected, then the Company is requesting a cost on equity of 11.00%.

Q. Do you believe that a 25 basis point reduction in cost of equity is appropriate if the Company's proposed modified fixed variable rate structure is accepted?

A. No, the Company's proposed 25 basis point reduction is wholly inadequate. As noted earlier, the Company's filing is predicated on shifting as much risk as possible from shareholders to ratepayers. The Company's proposed rate structure will eliminate virtually all revenue risk. As designed by DPL, and as discussed in more detail below, the Company's proposal will result in flat rate customer and demand charges for virtually all customers. Thus, DPL will receive the same amount of distribution revenue regardless of variations in usage. Moreover, the Company will be protected from revenue fluctuations for any reason, i.e., weather, conservation, economic conditions, more efficient appliances, etc. This results in a tremendous benefit to shareholders, one that is worth considerably more than the 25 basis point reduction proposed by DPL.

Q. How did you quantify the impact of the proposed modified fixed variable rate structure on the Company's risk?

A. The Company currently faces two kinds of risks. First, it faces the risk of reduced revenues due to multiple factors, including the factors discussed above. Second, it faces the risk of increased costs. In order to compensate ratepayers for taking on this risk, shareholders are rewarded with a return on equity risk premium. This risk premium is intended to compensate shareholders for the increase in risk that they bear relative to bondholders. Returns to bondholders are fixed by the parameters of the various bonds that they purchase. Returns to shareholders are not fixed, but instead vary depending upon the Company's earnings. Moreover, the Company's earnings are impacted by both its revenues and its costs. The proposed rate design eliminates one of these two sources of risk, i.e., revenue risk, from shareholders. It is important to recognize, however, that this risk is not entirely eliminated; it is simply transferred from shareholders, who currently bear this risk, to ratepayers. Therefore, if the Company's proposed rate design is approved, ratepayers will be bearing significantly higher risks while shareholders will receive a significant risk reduction.

If the Company's proposed rate design is accepted, I recommend that the Commission reduce DPL's return on equity premium by 50% to reflect the fact that one of the two risk parameters (revenues and costs) will be eliminated. As discussed below, I first calculated DPL's cost of equity assuming that shareholders will continue to bear the risk of revenue fluctuations. That analysis resulted in a cost of equity of 9.58%. Since the Company's cost of debt is 5.45%, the resulting risk premium is 4.13%. I then reduced this risk premium by 50% to 2.07%. Therefore, I am recommending a cost of equity for DPL of 7.52% (5.45% cost of debt + 2.07% equity risk premium). This recommendation provides a better valuation of the reduction in risk that results from the proposed rate structure than the 25 basis point reduction proposed by the Company. The Company's 25 basis point reduction is wholly inadequate and should be rejected outright by the Commission.

Q. How did you develop your cost of equity recommendation, prior to the risk adjustment discussed above?

A. As noted, I first developed a recommended cost of equity based on traditional methodologies, and assuming a traditional rate structure. Accordingly, I utilized both the Discounted Cash Flow ("DCF") methodology as well as the Capital Asset Pricing Model ("CAPM"). It is my understanding that the Commission has traditionally relied upon the DCF methodology for determining cost of equity for a regulated utility and therefore I have given greater weight to my DCF result.

Q. Please describe the DCF methodology.

A. The DCF methodology is the most frequently used method to determine an appropriate return on equity for a regulated utility. The DCF methodology equates a utility's return on equity to the expected dividend yield plus expected future growth for comparable investments. Specifically, this methodology is based on the following formula:

$$\text{Return on Equity} = \frac{D_1}{P_0} + g$$

where "D_1" is the expected dividend, "P_0" is the current stock price, and "g" is the expected growth in dividends.

In order to ensure that the return on equity determined for a particular utility is representative of returns for comparable investments of similar risk, the DCF methodology examines returns for similar companies through the use of a "comparable" or "proxy" group.

Q. How did you determine the proxy group to use in your analysis?

A. I utilized the same companies in my comparable group as those utilized by Company Witness Morin in his testimony. However, Dr. Morin segregated these companies into two proxy groups, one for combination electric and gas companies followed by Value Line Investment Survey and one for companies included in the Standard and Poor's Electric Utility Index. The result of Dr. Morin's analysis is that some companies appear twice, once in each proxy group, while others do not. Therefore, Dr. Morin has given twice as much weight to those companies that are included in both groups, such as Ameren Corp., Entergy Corp., and Wisconsin Energy, than to companies that are only included in one group, such as

Allegheny Energy, CenterPoint Energy, and PPL Corp. This creates a natural bias in his results. In order to avoid giving greater weight to some companies than to others, I have combined the companies selected by Dr. Morin into one comparable group.

To determine an appropriate dividend yield for these comparable companies, i.e. the expected dividend divided by the current price, I calculated the dividend yield for each of the comparable companies under two scenarios. First, I calculated the dividend yield using the average of the stock prices for each company over the past three months. The use of a dividend yield using a three-month average price mitigates the effect of stock price volatility for any given day. Based on the average stock prices over the past twelve months, and the current dividend for each company, I determined an average dividend yield for the comparable group of 4.81 %, as shown in Schedule ACC-4. I also calculated the current dividend yield at January 29, 2010, which showed an average dividend yield for the comparable group of 4.84%, also shown in Schedule ACC-4. Finally, I examined the average dividend yields as reported in the January 2010 AUS Utility Reports, which showed an average dividend yield for electric companies of 4.2% and an average yield for combination electric and gas companies of 4.4%. Based on all of this data, I recommend that a dividend yield of 4.81% be used in the DCF calculation. This dividend yield will be increased by one-half of my recommended growth rate, as determined below, to reflect the fact that the DCF model is prospective and dividend yields may grow over the next year. Increasing the dividend yield by one-half of the prospective growth rate is commonly referred to as the "half-year convention."

Q. Did Dr. Morin also increase his dividend yields by one-half of his recommended growth rate?

A. No, Dr. Morin increased his dividend yields by 100% of his recommended growth rates. This has the effect of overstating future dividends. The reason for using the half-year convention is that companies do not all change their dividends at the same time, nor do they increase their dividends consistently each quarter. Dr. Morin's methodology wrongly assumes that each company will increase its dividends by the fully annualized growth rate within the next year. The half-year convention, on the other hand, recognizes the variation in dividend changes among companies and is therefore a more reasonable and realistic approach.

Q. How did you determine an appropriate growth rate to use in the DCF calculation?

A. The actual growth rate used in the DCF analysis is the dividend growth rate. In spite of the fact that the model is based on dividend growth, it is not uncommon for analysts to examine several growth factors, including growth in earnings, dividends, and book value.

As shown on Schedule ACC-5 and as summarized below, average five-year historic growth rates have ranged from 1.7% to 4.2%, while average historic growth rates over the past 10 years have ranged from (1.3%) to 3.3%.

Earnings – 5 Year Growth	3.3%
Dividends – 5 Year Growth	1.7%
Book Value – 5 Year Growth	4.2%
Earnings – 10 Year Growth	2.2%
Dividends – 10 Year Growth	(1.3%)
Book Value – 10 Year Growth	3.3%
Value Line Projections – Earnings	5.9%
Value Line Projections – Dividends	6.3%
Value Line Projections - Book Value	4.8%

The Value Line projected growth rates range from 4.8% for book value to 6.3% for dividends. Based on my review of both historic and projected growth rates, I recommend that a growth rate of 5.0% be utilized. This growth rate is well above both the five-year and ten-year historic growth rates in earnings, dividends, and book value. It is also above the projected five-year growth rate in book value. While it is lower than the projected five-year growth rates in earnings or dividends, security analysts have traditionally been overly optimistic in their forecasts, as demonstrated by recommendations made immediately prior to the most recent downturn in the market.

Q. What are the results of your analysis?

A. My analysis indicates a cost of equity using the DCF methodology of 9.96%, as shown below:

Dividend Yield	4.81%
Growth in Dividend Yield (1/2 X 5.0% X 4.81%)	0.12%
Expected Growth	5.00%
Total	9.93%

Q. How does your DCF recommendation compare with the DCF analysis presented by Dr. Morin?

A. Dr. Morin developed two DCF results for each of his two comparable groups of companies. In one case Dr. Morin utilized analysts' earnings forecasts for his growth rate and in his second scenario Dr. Morin utilized the Value Line projected earnings growth rate. Dr. Morin then adjusted each of his analyses to reflect the addition of flotation costs, resulting in costs of equity ranging from 10.7% and 11.6%. Dr. Morin apparently did not examine or consider historic growth rates in his analysis.

The most significant difference between Dr. Morin's cost of equity recommendation and my recommendation is that Dr. Morin used inflated growth rates. His analyses reflect growth projections from 5.5% to 6.7%, an average of 115 basis points higher than the 5.0% growth rate that I recommend. The impact of Dr. Morin's inflated growth rate is magnified by the fact that Dr. Morin increased his dividend yield by a full year of growth, while I employed the half-year convention. In addition, Dr. Morin included flotation costs in his proposed cost of equity, while I did not.

Q. Why did you reject Dr. Morin's adjustment to include flotation costs in your DCF analysis?

A. I rejected Dr. Morin's flotation cost adjustment for two reasons. First, DPL doesn't issue common stock to the public. Therefore, the flotation costs that might be present with a publicly-traded stock are not incurred by DPL. Second, Dr. Morin's flotation cost adjustment was considered, and rejected, by both the Hearing Examiner and by the Commission in the Company's last electric base rate case. For these reasons, DPL's proposed flotation cost adjustment should be denied.

Q. Did you also calculate a cost of equity based on the CAPM methodology?

A. Yes, I did.

Q. Please provide a brief description of the CAPM methodology.

A. The CAPM methodology is based on the following formula:

B.

Cost of Equity = Risk Free Rate + Beta (Risk Premium)

or

$$\text{Cost of Equity} = R_f + B(R_m - R_f)$$

The CAPM methodology assumes that the cost of equity is equal to a risk-free rate plus some market-adjusted risk premium. The risk premium is adjusted by Beta, which is a measure of the extent to which an investor can diversify his market risk. The ability to diversify market risk is a measure of the extent to which a particular stock's price changes relative to changes in the overall stock market. Thus, a Beta of 1.00 means that changes in the price of a particular stock can be fully explained by changes in the overall market. A stock with a Beta of 0.60 will exhibit price changes that are only 60% as great as the price changes experienced by the overall market. Utility stocks have traditionally been less volatile than the overall market, i.e., their stock prices do not fluctuate as significantly as the market as a whole, and therefore their Betas have generally been less than 1.0.

Q. How did you calculate the cost of equity using the CAPM?

A. My CAPM analysis is shown in Schedule ACC-6. First, I used a risk-free rate of 4.57% for the yield on long-term U.S. Government bonds, which was the rate for thirty-year bonds at January 28, 2010, per the Statistical Release by the Federal Reserve Board. Over the past year, this rate has ranged from 3.45% to 4.76%. In addition, I used the average Beta for the proxy group. This resulted in an average Beta of 0.74, as shown in Schedule ACC-7. Finally, since I am using a long-term U.S. Government bond rate as the risk-free rate, the risk premium that should be used is the historic risk premium of stocks over the rates for long-term government bonds. According to the Ibbotson Associates' publication, *2008 Valuation Yearbook: Market Results for Stocks, Bonds, Bills, and Inflation, 1926-2007,* the risk premium of stocks relative to long-term risk-free rates using geometric mean returns is 5.35%.

Q. What is the difference between a geometric and an arithmetic mean return?

A. An arithmetic mean is a simple average of each year's percentage return. A geometric mean takes compounding into effect. As a result, the arithmetic mean overstates the historic return to investors. For example, suppose an investor starts with $100. In year 1, he makes 100% or $100. He now has $200. In year 2, he loses 50%, or $100. He is now back to $100.

The arithmetic mean of these transactions is 100% - 50% or 50%/ 2 = 25% per year. The geometric mean of these transactions is 0%. In this simple example, it is clear that the geometric mean more appropriately reflects the real return to the investor, who started with $100 and who still has $100 two years later. The use of the arithmetic mean would suggest that the investor should have $156.25 after two years ($100 X 1.25 X 1.25), when in fact the investor actually has considerably less. Therefore, a geometric mean return is a more appropriate measure of the real return to an investor, if it is used as I am using it here, i.e., to develop an historic relationship between long-term risk free rates and market risk premiums. Some utility companies have argued in the past that an arithmetic, rather than geometric mean return should be used, since the arithmetic mean return is more predictive of future results. However, in my case, I am not using the mean to develop an expected outcome, I am simply using the mean returns to develop an historic relationship. Therefore, the geometric mean is the appropriate measure, as illustrated in the above example.

Q. What is the Company's cost of equity using a CAPM approach?

A. Given a long-term risk-free rate of 4.57%, a Beta of 0.74, and a risk premium of 5.35%, the

CAPM methodology produces a cost of equity of 8.53%, as shown on Schedule ACC-6.

Risk Free Rate + Beta (Risk Premium) = Cost of Equity

4.57% + (0.74 X 5.35%) = 8.53%

Dr. Morin performed two versions of the CAPM analysis, resulting in recommendations of 9.4% and 9.8%, each of which includes an adjustment of 30 basis points to reflect flotation costs. Dr. Morin's unadjusted CAPM results of 9.1% and 9.5% are based on an inflated risk premium.

Q. Based on your analysis of the DCF and CAPM results, what cost of equity are you recommending in this case?

A. The DCF methodology and the CAPM methodology suggest that a return on equity of 8.44% to 9.96% would be appropriate. Since I recognize that the Commission has generally relied primarily upon the DCF, I have weighted my results with a 75% weighting for the DCF methodology and a 25% weighting for the CAPM methodology. This results in a cost of equity of 9.58%, as shown below:

DCF Result	9.93% X 75% =	7.45%
CAPM	8.53% X 25% =	2.13%
Total		9.58%

Q. Why is your recommendation substantially lower than the cost of equity recommended by Dr. Morin?

A. As noted above, Dr. Morin's DCF reflects an unrealistic high growth rates, reflects a full year of growth to the dividend yield, and reflects flotation costs. His CAPM result is based on an inflated risk premium and includes flotation costs. It is interesting to note that in his testimony, Dr. Morin appears to give greater weight to his DCF results than to its CAPM results. The average and mean of his various return on equity calculations is 10.7% and 10.9% respectively, yet Dr. Morin concludes that the return on equity should be 11.0%, prior to adjustment for the proposed straight fixed variable rate design. In the Company's last base rate case, PSC Docket No. 05-304, Dr. Morin largely dismissed his DCF result, on the basis that it was too low. Thus, it appears that Dr. Morin picks and chooses his methods based on obtaining a desired result. I have consistently calculated the cost of equity using the DCF and CAPM methodologies and applied a 75%/ 25% weighting to each method.

Q. What is the overall cost of capital that you are recommending for DPL?

A. Based on a 75% DCF /25% CAPM weighting of the cost of equity, under a traditional ratemaking approach DPL would have a cost of equity of 9.58%, as shown in Schedule ACC-1. However, as discussed above, I am recommending that the Company's equity risk premium be reduced by 50%, due to the significant reduction in risk that will result if the Commission accepts the proposed new fixed variable rate design. The Company has a cost of debt of 5.45%. Therefore, the equity risk premium is 413 basis points. 50% of this risk premium, or 207 basis points, should be added to the cost of debt to determine an appropriate cost of equity, assuming that the new rate structure is adopted. Therefore, if the new modified fixed variable rate structure is adopted, I recommend a cost of equity for DPL of 7.52%.

C. <u>Overall Cost of Capital</u>

Q. What is the overall cost of capital that you are recommending?

A. I am recommending an overall cost of capital for DPL of 6.43%, based on the following capital structure and cost rates:

	Percentage	Cost	Weighted Cost
Long Term Debt	52.48%	5.45%	2.86%
Common Equity	47.52%	7.52%	3.57%
Total	100.00%		6.43%

If the Commission grants DPL's request to include CWIP in rate base or its request to recover certain costs associated with the PHI credit facility, then the overall cost of capital should be reduced further to reflect the inclusion of short-term debt in the Company's capital structure.

V. RATE DESIGN ISSUES

A. Modified Fixed Variable Rate Design

Q. Please provide a brief history of the decoupling issue.

A. In its last natural gas base rate case, PSC Docket No. 06-284, DPL proposed a Bill Stabilization Adjustment ("BSA"), a decoupling mechanism that would have severed the relationship between gas revenues and gas sales. In that case, the Company proposed a monthly adjustment mechanism that would have compared the actual revenues collected each month with the revenues determined in its most recent base rate case, adjusted for changes in the number of customers. DPL proposed that any difference between the actual and baseline revenues would then be converted to a rate per CCF and added to, or subtracted from, customers' bills in a subsequent month. The Company proposed that the BSA be subject to an adjustment cap of +/- 10%. It also proposed that adjustments exceeding this cap would be deferred to later months. DPL proposed this surcharge mechanism in order to compensate the Company between base rate cases for changes in consumption due to the Company's conservation efforts. The Company argued the most of its distribution costs are fixed costs, and therefore the Company's utility operating income declines when DPL is successful in promoting conservation.

In the Stipulation in that case, the parties agreed to "participate in any generic statewide proceeding initiated by the Commission for the purpose of investigating Bill Stabilization Adjustments or decoupling mechanisms for electric and gas distribution utilities."[3] The PSC subsequently initiated Regulation Docket No. 59 on March 27, 2007 to address whether to implement a revenue decoupling mechanism for the electric and natural gas utilities subject to the PSC's jurisdiction.

Regulation Docket No. 59 was conducted as a series of workshops. The parties simultaneously conducted workshops in PSC Docket No. 07-28, which addressed the "Blueprint for the Future Application and Plan" that had been filed by DPL on February 6, 2007. PSC Docket No. 07-28 addressed the Company's proposals with regard to demand-side management (DSM"), advanced metering, revenue decoupling, and energy efficiency plans. In PSC Docket Regulation 59, the Company proposed a revenue decoupling surcharge mechanism, similar to the BSA that it had proposed in its prior rate case.

DPA fully participated in the workshops for Regulation Docket No. 59, including making presentations and the filing of written comments. DPA opposed the decoupling surcharge mechanism proposed by the Company, on several grounds. DPA opposed a decoupling mechanism that would compensate a utility for a revenue deficiency caused by factors other than measurable load reduction resulting from conservation efforts. DPA argued that the surcharge mechanism sent the wrong price signals to customers. DPA also argued that customer growth could offset the revenue impact of a decline in per customer energy usage. DPA expressed concerns about the impact of a decoupling mechanism on certain customers segments. DPA also noted that the proposed mechanism would lower the Company's cost of capital, a fact that had not been fully taken into account by the Company in its proposal.

3 Stipulation in PSC Docket No. 06-284, page 4.

In PSC Docket Regulation 59, Staff rejected the use of surcharges, but recommended that the PSC consider a Modified Fixed Variable Method ("MFVM) rate design as a possible mechanism to remove disincentives to conservation efforts and to more appropriately align fixed costs with the manner in which those costs are recovered.

On June 27, 2008, Hearing Examiner Ruth Ann Price issued the Findings and Recommendations of the Hearing Examiner in PSC Docket Regulation 59 and Docket 07-28. Her recommendations with regard to the decoupling issue were as follows:

(a) The Commission should determine that implementation of surcharges for energy efficiency programs and revenue deficiencies related to conservation efforts are not the preferred approach, but that the Commission not preclude the potential use of surcharges in the future under appropriate conditions;

(b) The Commission should investigate the potential implementation of a revenue decoupling mechanism for each utility in the context of the respective company's next base rate proceeding.[4]

The PSC primarily adopted the Hearing Examiner's Findings and Recommendations. However, the PSC refined certain portions of those Findings and Recommendations, and addressed Staff's recommendation with regard to the use of the MFVM rate design, as follows:

The Commission approves the adoption of Staff's recommendations regarding the potential adoption of a modified fixed variable rate design for Delaware distribution utilities in the

4 Findings and Recommendations of the Hearing Examiner, PSC Docket Regulation 59, June 27, 2008, paragraph 44(a) and (b).

context of a rate case proceeding; however, the Commission maintains the flexibility to address these rate design changes outside of a base rate case if the situation is warranted.[5]

Q. Did the Delaware General Assembly subsequently address this issue?

A. Yes, in late June 2009, the Delaware General Assembly adopted Senate Bill 106 and an accompanying amendment, which required utilities to implement decoupling mechanisms by December 2010. Specifically the legislation required that:

> Decoupled rate design mechanisms will be implemented by no later than December 2010 for regulated natural gas and electric utilities such that delivery rate structures provide for an appropriate, cost-based level of revenue recovery which will remove disincentives to investment in demand response programs and conservation and improved efficiency of energy use.

This legislation was signed into law by Governor Jack Markell on July 29, 2009.

Q. What was the Company's response to the Commission Order in PSC Docket Regulation No. 59 and to the legislation that required decoupled rate design mechanisms to be implemented by December 2010?

A. On June 25, 2009, even prior to the final passage of Senate Bill 106, DPL filed an Application proposing to implement a modified fixed variable rate designs for its electric utility.[6] I assume that DPL was well aware of the pending legislation when it prepared these filings. On November 3, 2009, in Order No. 7681, the PSC consolidated that filing with the Company's pending electric base rate case.

5 Order in PSC Docket Regulation 59, September 16, 2008, page 5.

6 On June 25, 2009, DPL filed a similar Application for the gas utility. Testimony in that case was filed by DPA and Staff on November 19, 2009. The procedural schedule in that case was subsequently suspended, at the request of the Company, and the parties have begun to engage in a series of workshops.

Q. Please describe the major components of the Company's proposal.

A. DPL is proposing to eliminate all volumetric billing for its electric distribution revenue requirement. Instead of billing customers based on their usage, the Company is proposing to implement a new two-part rate structure consisting of a monthly customer-related charge and an annual demand-related charge. Demand costs would be recovered through a new billing determinant, called the Distribution Demand Contribution "(DDC") Factor.

Delmarva proposes that distribution costs be allocated between customer charges and demand-related charges based on the results of the functional allocations in its cost of service study. The customer charges would then be allocated over the number of customers in each rate class.

DPL proposes to calculate a specific DDC Factor for each customer based on the Transmission Peak Load Contribution ("PLC") for each customer premise, which is currently calculated on a customer-specific basis. It is my understanding that the Transmission PLC is normalized for weather. The sum of these individual DDC Factors would then be aggregated and compared with the overall aggregate demand for the class. A reconciliation process would be used to ensure that the sum of the individual demands equaled the aggregated demand. In addition, the Company plans to develop a DDC for each customer premise.

Q. Is the new rate structure being proposed for all rate classes?

A. As stated by Mr. Janocha at page 8 of his Direct Testimony, the new rate structure would apply to all service classifications except for GS-T, General Service Transmission and the lighting service classifications OL Outdoor Lighting and ORL, Outdoor Recreational Lighting.

Q. How often will the individual DDC factors and DDC rates be calculated under the Company's proposal?

A. The Company is proposing that the DDC factor for each customer premise, and the DDC rates, would be calculated as part of a base rate case. The Company is not proposing to change either a customer's DDC factor or the DDC rate between base rate cases. The Transmission PLC is recalculated each year. Hence, after initial rates are set, the DDC factor is likely to differ from the Transmission PLC in subsequent years, until rates are reset as part of the next base rate case.

Q. Is the Company proposing to apply a uniform rate each month?

A. Yes, the DDC charge is an annual charge, and customers would pay 1/12th of the charge each month. According to the testimony of Mr. Janocha at pages 12-13, the fixed DDC billing determinant is based on peak summer loads and therefore it is dependent upon summer usage patterns. Therefore, the bill impact is dependent upon the relationship between a customer's summer usage and their usage during the rest of the year. A customer with stable usage throughout the year will be less impacted than a customer with summer usage that significantly exceeds the average usage during the non-summer months.

Q. Will the Company's proposal have any impact on class cost of service allocations?

A. The Company's proposal is not expected or intended to have any impact on proposed cost of service allocations.

Q. What will be the impact of the proposed rate design on DPL's residential customers?

A. The impact on any specific customer will depend on that customer's individual DDC factor and on the level of rate increase, if any, that is granted by the PSC in this case. However, in order to isolate the impact of the rate design change, it is helpful to examine the impact on various customer classes assuming revenue neutrality, i.e., assuming no revenue increase. In Schedule JFJ-4 of his testimony, Mr. Janocha demonstrated that at current revenues, it is expected that 73.49% of the residential customers will experience a total bill impact of plus or minus 5%, ranging from a monthly rate increase of $3.88 to a monthly rate reduction of $9.78. Moreover, this schedule indicates that 91.49% of all residential customers will experience increases or decreases of plus or minus 10%, ranging from rate increases of $5.47 to rate reductions of $18.73 per month. A very small number of customers (0.13%) will have a total bill reduction of more than a 10% reduction, averaging $44.16. Under the Company's proposal, approximately 8.38% of residential customers will experience bill impacts of more than 10%, averaging an increase of $6.14 per month.

Q. Did the Company provide similar information for other classes of service?

A. The Company provided information on the overall bill to customers in the small general service (“ SGS”) class in the response to PSC-RD-13.[7] The Company’s response indicates that 40.69% of the SGS customers will experience a total bill impact of plus or minus 5%, ranging from a monthly rate increase of $4.13 to a monthly rate reduction of $6.99. This response also indicates that 66.62% of SGS customers will experience increases or decreases of plus or minus 10%, ranging from rate increases of $8.61 per month to rate reductions of $13.77 per month. Approximately 3.98% of SGS customers are expected to have total bill reductions of more than 10%, averaging $20.46 per month. Although the Company’s response indicates that 29.39% of SGS customers will have total bill increases of more than 10%, the average increase for these customers is only $8.48 per month.

With regard to medium general service (“MGS”) customers, 69.58% of the customers will experience a total bill impact of plus or minus 5%, ranging from an average monthly rate increase of $21.91 to a monthly rate reduction of $60.42. 86.09% of MGS customers will experience increases or decreases of plus or minus 10%, ranging from average rate increases of $25.61 per month to average rate reductions of $96.88 per month. A very small percentage, about 0.31%, of MGS customers are expected to have total bill reductions of more than 10%, averaging $183.98 per month, while 13.60% of MGS customers will have total bill increases of more than 10%, the average increase for these customers being $26.53 per month. Virtually all of the large general service customers (“LGS”) will experience increases of no more than 5%, or an average of $79.02 per month.

7 The Company’s response with regard to SGS and MGS customers was revised on January 25, 2010.

Q. Did the Company provide similar information about the impact of its proposal on distribution rates, as opposed to the impact on a customer's total bill?

A. The Company did not provide similar information about the impact of its proposal on distribution rates for the residential class. It did provide such information for the non-residential classes in the response to DPA-RD-7. According to that response, the Company's proposed rate design would have a much greater percentage impact on the distribution portion of the bill than on the total bill. For example, 46.95% of the SGS customers will experience a distribution increase of more than 10%, with the average increase for this group being $7.40. Only 14.97% of SGS customers will experience distribution rate changes of plus or minus 5%. With regard to MGS customers, 51.27% of such customers will experience a distribution bill increase of more than 10%, and the average increase will be $22.69. Similarly, 42.13% of LGS customers will experience a distribution increase of more than 10%, averaging $243.59.

This response demonstrates that the impact of the Company's proposal depends in part on the level of supply costs currently being paid by customers. In addition, this analysis was prepared at present revenue levels. Thus, the impact on ratepayers will be increased if the Commission approves a rate increase for DPL in this case.

Q. Do you recommend that the Company's modified fixed variable rate structure proposal be adopted by the PSC?

A. As noted above, the Delaware General Assembly has mandated that Delaware electric and gas utilities adopt some form of decoupling mechanism by December 31, 2010. The

Company's proposal is far superior to the BSA that DPL proposed in its last gas base rate case and in PSC Docket Regulation No. 59. The Company's proposal will result in a ratemaking methodology that more closely matches the current regulatory framework, whereby base rates are established in a base rate case proceeding and remain unchanged between base rate case filings. The true-up mechanism in the BSA sent the wrong price signals to customers by imposing higher surcharges as customers increased their conservation efforts. The current proposal does not require an annual true-up mechanism and it is much easier to administer than the BSA. For these reasons, I am generally supportive of the Company's proposal. However, I do have some concerns about the Company's proposal. Specifically, I have concerns about a) how new customers would be billed, b) the impact of the modified fixed variable rate structure on specific customers, c) the impact of the proposal on the Company's cost of equity, and d) the customer education efforts that will be required if the proposed rate structure is adopted.

Q. How will new customers be billed under the Company's proposal?

A. The Company has provided few details of the mechanics of its proposal in its testimony. However, it is my understanding that new customers moving into a new premise would be billed at the average DDC for the class. Since the Company will be calculating a DDC for each premise, new or existing customers moving into an existing premise will be billed at the current DDC of that premise.

Q. Does the DPA have any concerns with that proposal?

A. While the DPA recognizes that this methodology is imprecise, we believe that it is a reasonable proposal, at least initially. With regard to existing premises, the current DDC should provide a good estimate of demand for the new ratepayer, particularly with regard to residential customers. The Company's proposal to utilize the class average DDC for new customers moving into a new premise is likely to be less precise. There are likely to be customers moving into small seasonal new homes or new more efficient homes whose actual DDC will be below the class average. They are likely to be even greater variations among commercial customers. Therefore, I recommend that the Company utilize the class average DDC for new customers moving into a new premise for the first year. After one year, I recommend that the Company calculate a customer-specific DDC for new customers that move into a new premise. This should be easily accomplished, since the Company will be calculating a Transmission PLC for these customers that can easily be translated into a DDC for the premise. This customer-specific DDC should then be used until the Company's next base rate case. If the Company is concerned that the first few months of occupancy may not be representative of ongoing demand, then I would not object to calculating actual customer-specific usage after some slightly longer period, e.g., fourteen months, based on actual results for the preceding twelve-month period.

Q. How will revenues from new customers be treated?

A. Unless there have been cost increases since the last base rate case, all distribution revenue from new customers will accrue to the benefit of shareholders. This is similar to the situation that exists today. The PSC should continue to monitor the Company's earnings between base rate case proceedings to determine to ensure that growth in customers, or other factors, do not result in excessive earnings. If the PSC finds that the modified fixed variable rate structure, or any other factor, is resulting in over-earnings by the Company, it can and should take appropriate steps to initiate a rate investigation, just as it does today under the current rate structure.

Q. Should the Commission initiate a further review of the impact of the proposed modified fixed variable rate design to ensure that there are no unintended results?

A. Yes, it should. As noted, the Company has provided some information about the likely impact of the proposal on the distribution bill and total bill of various customer classes. While it appears that the impact on most customers will be acceptable, there may be outliers in each rate class for whom the new rate structure would have unreasonable impacts. Therefore, the Company should provide additional information about the specific customers who are expected to experience significant increases with the new rate design. While it appears that on a nominal dollar basis, the dollar impact on most customers that experience an increase of more than 10% will not be unreasonable high, the Company should provide additional documentation to the parties with regard to customers experiencing increases of more than 10%. Moreover, this documentation should be provided for a range of possible outcomes with regard to the Company's request for an increase in base rates.

Q. What impact will the Company's proposals have on its costs?

A. The primary impact will be a significant reduction in the Company's cost of capital. This proposal will greatly reduce shareholder risk, which has already been largely eliminated by the adoption of recovery clauses and other mechanisms that guarantee the utility dollar-for-dollar recovery. The only portion of its revenue requirement that is still at risk is the delivery revenue that is currently collected on a volumetric basis. This is only a portion of the total delivery revenues currently being collected, i.e., the delivery charges that are currently being collected through a volumetric rate element. All customer charges and demand charges for some rate classes are already recovered on a fixed basis. If a modified fixed variable rate structure is adopted, the Company and its shareholders will be even more insulated from business risk, a factor that must be considered when establishing a reasonable cost of equity for DPL. As previously discussed, if the modified fixed variable rate design is approved, it must be implemented along with a significant reduction to the Company's cost of equity to reflect this reduced risk to shareholders.

Q. What do you see as the biggest challenge to implementation of the Company's proposed modified fixed variable rate structure?

A. I believe that the biggest challenge will be customer education. The Company has not prepared any customer education materials at this time. In response to PSC-RD-33, DPL indicated that "[t]he Company anticipates that the customer education process on the new rate design would include the use of its monthly customer newsletter, and a detailed bill insert. Such material will be provided as they are developed." I believe that there could be significant customer confusion when a new modified fixed variable rate design is implemented. Therefore, it is critical that no rate design change be implemented unless and until the Company can demonstrate to the Commission that it has prepared a comprehensive education program for customers, and that it has adequate resources to address the many inquiries and complaints from customers that it is likely to receive.

Q. How do you propose that details concerning implementation of the new rate design be resolved?

A. I propose that the parties in this case begin a series of workshops to examine issues such as the potential impact on customers that are expected to receive bill increases of more than 10% and to ensure that appropriate customer education programs are in place prior to implementing the new modified fixed variable rate design. The parties have initiated such a workshop to examine similar issues with regard to the gas utility and it appears that this forum will be successful in resolving outstanding issues prior to implementation.

B. <u>Telecommunications Network Service Rate</u>

Q. Is the Company proposing a new rate class for cable television operators?

A. Yes, it is. As discussed on page 14-16 of Mr. Janocha's testimony, the Company is proposing to implement a new Telecommunications Network ("TN") Service rate "to meet the unique needs and load characteristics of power supplies used in the systems of cable television operators." The Company is proposing to charge these customers a two-part rate, consisting of a customer charge and a charge "for the predicated consumption level of the power supply devices." DPL proposes that the consumption level be determined based either on the manufacturer's average power level or on historical metered data, at the customer's option. The customer charge and consumption charge would be established initially at 100% of the class's cost of service.[8]

DPL claims that a new rate schedule for these customers is appropriate, since these power supplies have constant and highly predicable consumption factors, operating at fairly high load factors.

Q. How many customers are expected to be eligible for service under the new rate class?

A. According to the response to DPA-RD-6, only one customer would be included in this rate. I presume that this customer is Comcast.

Q. What impact would the new rate class have on the rates paid by Comcast?

A. On page 15 of his testimony, Mr. Janocha stated that the cable operator power supplies are currently being billed as separate metered SGS-S accounts. However, according to the response to DPA-RD-1, there are also many MGS that would be eligible for the new rate. Moreover, as shown in that response, implementing the new rate would shift revenue away from Comcast and put a higher revenue burden on other small and medium commercial customers. Mr. Janocha estimated that there would be a revenue shift of approximately $196,750 from Comcast to other customers if the Company's proposal is adopted.

8 It should be noted that in the response to DPA-RD-1, the Company stated that it had not included operating expenses when determining the proposed TN rate. The Company noted that it was revising its proposed TN rates to incorporate operating expenses.

Q. Is the Company's proposal inconsistent with the move toward recovery of costs based on fixed charges?

A. Yes, it is. The Company is proposing to eliminate volumetric charges for the vast majority of its customers because it claims that its distribution costs are fixed. However, it also argues that one cable telecommunications company deserves a special rate, due to its usage pattern for electricity. Usage patterns would only justify a different rate if the Company's costs were dependent upon usage, a claim that the Company now denies. Accordingly, there is no theoretical rationale for establishing a separate rate class for cable telecommunications, especially when one considers the fact that the new rate class will result in higher rates for other commercial customers.

Q. What do you recommend?

A. I recommend that the Company's proposal to establish a new TN rate class be denied. The Company's proposal would only serve to benefit cable operators, at the expense of other commercial customers. Moreover, it appears that this rate would serve only one customer, Comcast. The Company's proposal is also inconsistent with its argument that distribution costs are fixed and should be recovered on a fixed cost basis independent of usage. For these reasons, Comcast's accounts should continue to be included under the SGS or MGS rate schedules, depending on the characteristics of the respective accounts.

VI. OTHER POLICY ISSUES

A. Deferred Pension Costs

Q. Please provide a brief history of the deferred pension issue from PSC Docket No. 09-182 that has now been consolidated with this base rate case.

A. On May 1, 2009, DPL filed a Petition (Docket No. 09-182) with the PSC requesting authorization to defer, for regulatory accounting purposes, certain costs incurred with respect to its 2009 pension costs. The Company stated in its Petition that DPL's pension costs would increase significantly in 2009 from earlier years, due to the turndown in the economy during 2008. As stated in the Petition, "As a direct result of this downturn in the U.S. economy, the Pension Plan experienced a significant decline in the fair value of its assets, which will result in a significant increase in the annual pension expense in 2009."[9] The Company noted that "[t]he Delaware electric distribution operations of Delmarva are expected to incur an O&M pension expense of approximately $7.249 million for the year ended December 31, 2009, and its gas operations are expected to incur an O&M expense of approximately $1.67 million for the twelve months ending December 31, 2009. These anticipated 2009 O&M expense levels represent increases over the amounts reflected in current rates of approximately $8.2 million in the electric distribution business and approximately $1.8 million for the gas business."[10]

On January 7, 2010, the PSC issued Order No. 7727. In its Order, the PSC found that "the recovery, if any, of the difference between the Company's level of O&M pension expense attributable to the Company's Delaware electric customers currently included in base electric rates and the level of O&M pension expense for 2009 that the Company is required to record under generally accepted accounting standards shall be considered and addressed in the Electric Base Rate Case (PSC Docket No. 09-414/PSC Docket No. 09-276T)." On January 13, 2010, DPL filed Supplemental Testimony on this issue sponsored by Mr. Ziminsky. In his testimony, Mr. Ziminsky requested recovery of a regulatory asset of $8.972 million over a three-year period. In addition, the Company requested carrying costs on the unamortized balance at the Company's overall weighted average cost of capital. Mr. Ziminsky stated that $8.972 represented the difference between the amount of pension expense included in currently effective rates and the Company's actual 2009 expense. The annual revenue requirement impact of the Company's proposal is an increase to ratepayers of $3.515 million, as quantified on Schedule JCA-3 to Mr. Ziminsky's testimony.

Q. Before addressing the merits of Mr. Ziminsky's position, do you agree that $8.972 is the amount currently included in base rates relating to the Company's pension expense?

A. No, I do not. The Company's calculation does not include the revenue requirement impact of the pension asset included in rate base in the last base rate case. It is important to recognize that this pension asset was not related to a cost deferral, as is being requested here. Rather, the pension asset was related to the Company's claim that it should be made whole for pension amounts funded in excess of its actuarially determined costs. The Company's current rates include a pension asset of $16,648,593 million. As shown in the response to DPA-P-2, this pension asset results in an additional amount of $1,758,180 being collected from current ratepayers relating to pension costs. Therefore, even if the PSC accepts the

9 Petition of May 1, 2009, paragraph 6.
10 Id, paragraph 7.

Company's proposal to defer 2009 pension costs for future recovery, the Company's claim is overstated by $1,758,180.

Q. Turning to the basic issue, should the PSC approve recovery of these 2009 pension costs?

A. No, it should not. The Company's request for future recovery of these past costs, along with carrying costs on the unamortized balance, is another attempt to shift risk from shareholders to ratepayers. While pension costs may have increased in 2009 relative to levels that are currently being recovered in base rates, DPL's shareholders were awarded a 10.0% return on equity in the Company's last base rate case. The reason that shareholders received this premium it because they were expected to take risks, including the risk of expense increases. Now that one of those risks has actually resulted in a negative outcome, it is unreasonable for shareholders to expect ratepayers to reimburse DPL for these cost increases. DPL's position is a bit like having ratepayers buy insurance against a negative event, and then when the event happens, having the insurance company refusing to pay.

Q. Did ratepayers also experience a significant downturn in the economy in late 2008 and early 2009?

A. Yes, they did. While shareholders faced higher than expected pension costs due to declines in the market value of the pension fund, ratepayers were also impacted by the downturn in the economy. In addition to suffering the same market declines that impacted DPL's pension costs, ratepayers also suffered record job losses, sharp declines in home values, unprecedented foreclosure rates, and other economic impacts. On top of all of this, ratepayers are now being asked to a) pay higher utility rates, b) pay utility rates that can no longer be controlled by controlling usage, and c) pay for past cost increases experienced by DPL. Something is wrong with this scenario.

Q. Do you believe that there are ever circumstances that could warrant requiring ratepayers to pay for higher than expected previously-incurred costs, as is being requested here?

A. Yes, I do. I believe that it may be reasonable to ask ratepayers to reimburse shareholders for higher than expected past costs if the financial integrity of a utility is jeopardized to the point where the utility may no longer be able to provide service. In that case, it may be appropriate to ask ratepayers to ignore the regulatory compact that gives shareholders a premium return in exchange for taking on increased risk. However that is certainly not the case here.

While DPL's 2009 electric earnings were impacted by higher pension costs, Delmarva still paid its parent company, Pepco Holdings, Inc., dividends of $28 million during the first nine months of 2009.[11] In this same period, PHI paid $178 million in dividends to its shareholders. Moreover, PHI's dividend payment to its public shareholders is well above the industry average. According to the January 2010 AUS Utility Reports, Pepco Holdings, Inc's dividend is 6.3%, almost 50% higher than the average dividend of 4.4% paid by combination gas and electric companies. Thus, there is no indication that

11 To my knowledge, dividends for the full year have not yet been announced.

higher 2009 pension costs have jeopardized the financial integrity of either DPL or PHI, or that DPL is in any danger of not being able to provide safe and reliable service to Delaware ratepayers. Both DPL and PHI continue to maintain investment grade credit ratings. While credit rating agencies and security analysts always prefer higher corporate earnings over lower earnings, there is no indication that either DPL or PHI will suffer serious credit problems if the recovery of these past costs is denied.

Q. Has the economy rebounded somewhat over the past year?

A. Yes, it has. At least as measured by the Dow Jones Industrial Index ("DJII"), which is a measure of the market value of DPL's pension fund. According to the response to DPA-P-7, the market value of the pension fund was $1.505 billion at March 31, 2008. By March 31, 2009, the market value had declined to $1.053 billion and the DJII had declined from 12,263 to 7,609. While DPL has not yet released the market value of its pension fund at December 31, 2009, pending the filing of certain 2009 SEC reports, the DJII has rebounded to 10,271. Thus, while the market has not regained its entire value, it is 35% higher than it was in March 2009.

Q. Has DPL quantified the impact of its increased pension costs on its 2009 earnings?

A. No. In DPA-P-1, the Company was asked to provide the return on equity and overall rate of return "in each of the last three calendar years (including 2009)." Moreover, for 2009, the Company was asked to provide this information under two scenarios: assuming the deferral of pension costs and assuming no deferral. The Company's response was that it "has not performed these calculations." If this issue was one that had the potential to jeopardize DPL's financial integrity, one would have expected DPL to have made this calculation.

Q. Did DPL request recovery of 2009 pension costs in its recent base rate case in Maryland?

A. Yes, DPL made a similar request to the Maryland Public Service Commission. On August 13, 2009, the Secretary of the Maryland PSC issued a letter stating that "the Commission rejects Delmarva's Application. The Commission suggests Delmarva pursue the recovery of these pension costs as part of its pending base rate case." In that rate case, the PSC later rejected DPL's claim for recovery of past 2009 costs, finding, "[w]e found before that tracker mechanisms, like the surcharge and amortization proposals in this case, represent an extraordinary form of ratemaking that we reserve for very large, non-recurring expense items that have the potential to seriously impair a utility's financial well-being and that do not contribute to the Company's rate base."[12] The Maryland PSC also rejected a similar request for a regulatory asset deferral filed by Pepco.

Q. What do you recommend?

A. For the reasons stated above, I recommend that the Commission deny DPL's request to recover past 2009 pension costs from ratepayers. Shareholders were awarded a premium return for accepting the risk of expense increases between base rate cases. Neither the

12 Order in Maryland PSC Case No. 9192, page 15.

financial integrity of DPL nor of PHI will be jeopardized if the Company's request is denied. Finally, it is simply unreasonable to demand that ratepayers, who did not have such a great year in 2009 themselves, should be responsible for these costs while DPL continues to pay healthy dividends to PHI and while PHI continues to pay healthy dividends to its shareholders. The Delaware PSC should follow the lead of the Maryland PSC and deny the Company's request.

B. <u>Volatility Mitigation Rider Tracking Mechanism</u>

Q. Is the Company requesting a tracking mechanism to track, and true-up, variations in certain costs between base rate cases?

A. Yes, it is. In addition to seeking a new rate design that eliminates its revenue risk, the Company is also seeking a Volatility Mitigation ("VM") Rider to recover the costs of pension, OPEBs, and uncollectibles. The Company is proposing that the VM rider rate be reset annually, based on a three-year rolling average of these costs. The difference between the actual costs incurred by the Company each year and the amounts recovered under the VM rider would be subject to deferred accounting and would be subject to true-up as part of the annual rate adjustment. The Company is proposing to accrue carrying costs on the unamortized balance at its overall cost of capital. The tracker would initially be set to recover $8,584,589 per year.

Q. Should the PSC approve the VM rider as requested by DPL?

A. No, it should not. The VM rider results in single-issue ratemaking and should be rejected by the PSC. The current regulatory framework provides for utility rates to be established based on a test period selected by the Company and on an appropriate return on investment to shareholders and bondholders. Moreover, during that test period, the Company's revenues, expenses, and investment are matched. Shareholders are awarded a return on equity premium for accepting the risk that revenues and costs, including capital costs, can change between base rate cases.

The Company's surcharge proposal isolates a selected group of three expenses for reimbursement ratemaking treatment. Pension, OBEP, and uncollectible costs are costs that are integral to the utility business. There is no rationale for treating these costs differently from other elements of the cost of service, such as salaries and wages, Service Company costs, insurance costs, or outside services costs. The Company's proposal suggests a slippery slope down the path to reimbursement ratemaking. Accordingly, it should be rejected.

Q. Why shouldn't the Commission adopt reimbursement ratemaking for a regulated utility?

A. Reimbursement ratemaking violates the basic premise that regulation is a substitute for competition. In a competitive world, companies do not receive dollar-for-dollar recovery of all costs. In some years, a competitive company may earn more than its costs and in some years it may earn less. By turning utility ratemaking into a reimbursement system, the regulator becomes nothing more than an auditor reviewing a utility's books. Perhaps more importantly, reimbursement ratemaking removes important incentives for the utility to control costs.

Q. How does reimbursement ratemaking eliminate these incentives?

A. Reimbursement ratemaking eliminates these incentives because the utility is essentially guaranteed recovery of any costs that it can demonstrate it actually spent. While I understand that most surcharge mechanisms are subject to after-the-fact review by regulatory agencies, the fact is that there are very, very few disallowances by regulators of amounts that have actually been spent. Moreover, while I am not an attorney, I understand that in Delaware there is no legal requirement to demonstrate that an expense was prudent, a standard that does exist in many other jurisdictions.

Under the current regulatory framework, rates are established in a base rate case. To the extent that a utility can cut costs, shareholders benefit from increased earnings until rates are reset in the next base rate case. Moreover, if cost increases in any one area are greater than offsetting cost decreases, then the utility has a tremendous incentive to find ways to cut costs in order to maintain an acceptable level of return for its investors. The proposed VM rider would eliminate this incentive, and provide the Company with essentially guaranteed dollar-for-dollar recovery of these costs.

Q. Has the Company adjusted its cost of equity to reflect the reduced risk that would result if the VM rider is approved?

A. No, it has not. DPL has not proposed any adjustment to its cost of equity relating to a reduction in risk if the VM rider is adopted. It should be noted that the VM rider, like the new proposed rate design, does not reduce overall risk, it simply transfers that risk from shareholders to ratepayers. Thus, the VM rider would result in ratepayers accepting higher risk without a commensurate reduction to the equity premium being paid to shareholders.

Q. What do you propose?

A. I propose that the VM rider be rejected by the PSC. This mechanism would constitute single issue ratemaking, would eliminate DPL's incentives to control these costs, and would shift risk from shareholders to ratepayers without any commensurate reduction in the return on equity premium. Accordingly, it should be denied. As a result of this proceeding, the Company will experience a tremendous reduction in risk due to the adoption of a new rate modified fixed variable design. The PSC should not exacerbate this shift by adopting reimbursement ratemaking for costs that are integral to the Company's distribution business, such as benefit cost and uncollectibles. Instead, the PSC should be mindful of the fact that regulation is intended to be a substitute for competition, and should expect the Company and its shareholders to assume the risk of expense variations between base rate cases. If, in spite of my recommendation, the PSC does approve a VM rider for DPL, then it should also make a further reduction in DPL's cost of equity.

Q. Was a similar proposal rejected by the Maryland Public Service Commission in DPL's recent rate case in that state?

A. Yes, it was. In its Decision in PSC Case No. 9192, the Maryland PSC stated:

> We rejected similar proposals in Delmarva's last rate case because surcharges guarantee dollar-for-dollar recovery of specific costs, diminish the Company's incentive to control those costs, and exclude classic, ongoing utility expenses from the standard, contextual ratemaking analysis….Pension and OPEB expenses….even in a bad year - they are classic, ongoing costs of running a utility company, and cannot, in our view, qualify for specialized rate treatment. We find again, as we did in 2007, that a pension and OPEB surcharge breaches the historical ratemaking bargain, and the economic challenges of the last two years offer no reason for us to jettison these long-settled principles.[13]

For the reasons discussed earlier in my testimony, and articulated again by the Maryland PSC in its recent decision, the Company's request for a tracking mechanism should be denied.

Q. Does this conclude your testimony?

A. Yes, it does.

13 Id., pages 15-16.